THE CONTROL OF RETURN ON PUBLIC UTILITY INVESTMENTS

Professor Bauer, in his recent article in this REVIEW,[1] seems to maintain the thesis that control of return on investment should be the chief aim of legislators and commissioners rather than the fixing of so-called "reasonable" rates. This main proposition depends upon the following premises:

1. It is not only desirable but also generally possible to establish a simple and uniform basis of valuation.

2. A uniform, "definite rate of return and no more" should be alllowed upon the investment as determined by this valuation; and the investors are neither entitled to, nor in reality expect, greater returns.

That a definite and simple basis of valuation is highly desirable, no one can deny: its feasibility, however, is quite another matter. Granting that there were no inherent differences in the various utilities, the past diversities in accounting, management, legislation, and regulation, would make any single rule unfair if not unworkable. While these difficulties have been sufficiently emphasized in the article under consideration, certain other aspects of the question merit further attention.

Though it will doubtless be generally agreed that past excess or deficiency of profit can hardly be considered in a proper scheme of valuation, except indirectly, yet there seems to be an important exception in the case of comparatively new plants. It is true of many, perhaps of most, public utilities, that the business is likely to be carried on for some years at an abnormally small profit or even at a considerable loss. Under such circumstances, even though we may favor the strict regulation of profits, justice to all certainly demands that an addition to the valuation be made, proportionate to the difference between the "reasonable" return to be allowed in the future and the actual return received in the past. In lieu of this arrangement, the only other course to follow would be to allow a higher rate of profit than the usual rate, until stockholders should be recouped for former losses. The reasoning, of course, would not apply to a well-seasoned business, in spite of the fact that there had been losses. However, this exception, with the numerous complications which arise out of it, is sufficient to show

[1] "Bases of Valuation in the Control of Return on Public Utility Investments," AMERICAN ECONOMIC REVIEW, vol. VI (Sept., 1916), p. 568.

that any high degree of uniformity in practice is difficult of attainment as well as fundamentally unjust.

Again, aside from practical objections, it appears to be logically inconsistent to maintain generally, as Professor Bauer does, that "reproduction cost" should not include land granted by the public and that "net reproduction cost" should not make allowance for enhanced land values. There may be strong arguments in favor of this contention in the case of steam railways; but, so far as the gas and electric lighting industries are concerned—and probably the street railways—the case is different. Why should not land granted by the public be included? True, if the inclusion were made, some companies would have an advantage by so much over others which had to buy their land. But perhaps the promoters of the more fortunate concern secured the grant because of their superior bargaining ability, for which a return can reasonably be allowed. And, furthermore, the people gave the land, not because they hoped to secure lower rates by so doing, but because they expected that it would be to their interests to have the utility installed in their midst, bringing with it a general increase of land values and acting as a stimulus to business of every kind. In all such cases there is a *quid pro quo* which is frequently forgotten. The land granted, having a small primary value, increases in value along with other land in the community.

Viewed from another angle, all the capital that assists in the production of a utility should be awarded its full share of the profits, based upon a fair valuation, no matter what the ancient history of the case may be. The public is under no obligation to grant the land unless it so desires; but once the grant is made it becomes private property, and should be so regarded if the accounting is to be kept straight. Would any one maintain that a return on the value of land used by a municipally owned plant can be disregarded, if we wish to compute what the service *really* costs the public?

So far as enhanced land values are concerned, it is the popular thing to say that society gives the value and should reap any gains which might accrue from this increase. This, however, is only indirectly and perhaps ultimately true. Nor, in final analysis, is it more true of land than of many other instruments of production. The fact is that very frequently the *few* men who have invested their savings in a public service industry have in reality created increased values for the *many* whom that industry serves.

It is hardly accurate to criticise the "net reproduction cost" method—perhaps better called the "present reproduction cost," with depreciation allowance—on the ground that it would "capitalize present high prices" against the public. In all probability a year of *normal* prices would be taken as the standard of valuation, or the average of a series of such years. Nor is a valuation once made unchangeable. Rather, when a new question of rates arises, certain adjustments must be made to meet the changes in methods of production, cost of material, and such things. With a proper system of accounting, these adjustments should entail no great burden.

Regarding the allowance to be made for depreciation, the divergence of opinion is so great and the differences in local conditions are such that definite rules are admittedly out of the question. Under these circumstances the writer fails to see how any uniformity other than the most nominal can be reached either by means of the net reproduction-cost method or the net installation cost method. About all that can be done, if uniformity is insisted upon, is to set a certain safe minimum annual depreciation charge which is to be deducted from the reproduction cost or the installation cost. This procedure would of course give a decided advantage to the better organized plant and to the one in the more desirable locality. Hence there would be no real uniformity after all. The whole question of depreciation, however, is so much up in the air that some consideration might well be given to the theory of the National Electric Lighting Association, which contends that, provided a plant is kept at 100 per cent efficiency, the law should not concern itself about any fixed depreciation allowance. If we could call depreciation by some other name it might not make us so much trouble.

The writer feels that Professor Bauer has, to some extent, overlooked the psychology of the investor—who is in the beginning often something of a speculator—in his repeated assertions that all *that* individual expects is a "fair" return upon his original investment, as represented by conservatively issued securities or by the net installation cost, plus reinvested earnings in either case. The original investor in public utilities has frequently assumed heavy risks, for which he is entitled to more than a mere "fair" return—whatever that may be. At any rate, one who puts his money into public utilities is justified in expecting a high return on his investment, if at the same time the charge for the service

rendered has been proportionately reduced. The fact that monopoly power exists is not so significant as the manner in which that power is used. Under reasonable regulation both stockholders and the public should share the gains.

Is there any good reason why those who invest their capital in public service enterprises should receive a lower rate of return than others who invest in business of the same degree of risk? Any real enhancement of value of the property, from whatsoever cause, should, from the investor's point of view, rightfully increase profits. Would any one deny that a man who buys a house and lot in a city which begins to grow rapidly, has the right to rent or sell at an advanced price? The comparison should not be forced, but it is not so unsatisfactory as might at first appear. *Sacrifice at the time of investment must not be confused with present sacrifice.*

We are left totally in the dark as to what is meant by "reasonable." The broad grounds of "social expediency," the "general welfare," the "common good," and such other "social-ethical" considerations, are, to say the least, very vague. It could not well be otherwise. Such terms are always well sounding and always inconclusive. It is to be feared that, with such criteria to guide us, there would be as many different interpretations of what is "reasonable" as there are different interpreters. *Uniformity* could scarcely survive on such an ideal basis.

In conclusion, Professor Bauer appears to approach dangerously near to circular reasoning when he insists upon "a clear, single basis of valuation" and "a definite rate of return allowed on this amount and no more"—*all in the interests of "the common good."* The vastly significant question of the regulation of profits *versus* the fixing of rates is raised. To be sure, these two things may be different aspects of the same problem. Yet, whenever the first aim of legislators becomes the rigorous regulation of profits, the most important stimulus to individual initiative is taken away. Allowance for past losses in the case of a concern which has had time to "get on its feet" is indefensible; but *the failure to allow a premium for efficiency would be exceedingly disastrous.* The inducement of *probable* high returns has frequently been necessary in order to secure the capital needed to develop the country. The stimulus of *possible* high profits now and in the future is at the very basis of that enterprise which ultimately reduces the cost of service and leads to the advancement of society in general. Let

the dead level of uniformity of profits be introduced, and a premium will be put upon inefficiency, ability will be penalized, capital will seek more profitable fields, service will become inadequate, and prices will tend to remain far higher than they would have been without such "over-regulation." Competition can be kept on a high plane; as even a start as possible can be given; but if the economic race is to be worthy of the name, we must let the best man win!

The rigid regulation of profits is a specious scheme. It is a simple weapon, a popular weapon, and consequently a most dangerous weapon. Ultimately it may become a necessary weapon. But, carried to its logical conclusion, this method of control of the return on public utility investments can lead in only one direction—to the *socialistic state.* Whether or not that would be a desirable outcome is another question.

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